

AGENDA

FOCUS GROUP: FILING BY REGISTERED DOMESTIC PARTNERS

November 30, 2006

Thursday, 8:00 am-Noon

Franchise Tax Board, Town Hall, Golden State Room B

Conference Call-in: (916) 845-0610

Facilitators: Judi Bentzien, Christie Trykar

Attendees: Interested Parties

Meeting Preparation: Review Pre-meeting Materials: Sample Questions and Potential Answers

Meeting Objective: ➤ Determine how we can make filing of California individual income taxes by registered domestic partners as simple as possible.

Agenda Topics

	Topic	Person	Length
1	Kick-off Session	Selvi Stanislaus	8:15-8:20
2	Introductions	Anne Miller	8:20-8:40
3	Overview and Objective of Joint Session	Anne Miller	8:40-8:50
4	Generate Questions for Filing State Return(s) by Registered Domestic Partners <ul style="list-style-type: none">Review Methodology for Achieving Today's ObjectiveReview R&TC Sections 17024.5 and 18521Review Sample Questions/Potential AnswersRaise Additional QuestionsGroup Similar Questions	Group Patrick Kusiak/ Jozel Brunett	8:50-10:15

BREAK (10:15-10:30)

5	Develop Potential Answers to Questions	Group	10:30-11:45
6	Wrap Up <ul style="list-style-type: none">Sharing of Today's ResultsOpportunity for Future Discussion Topics	Anne Miller	11:45-NOON

New Law Affecting Filing Status of Registered Domestic Partners
Discussion Material for FTB Focus Group Meeting
DRAFT Questions and Suggested Responses
RESULTS OF FOCUS GROUP (in red)

Line #	Question:	Suggested Response:
1.	What is the operative date of the new law?	The new law applies for taxable years beginning on or after 1/1/07.
Notes	No input.	
2.	Which domestic partners are required to file as joint or married filing separate under the new law?	Those who are registered domestic partners as of the close of a taxable year.
Notes	Does this apply to registered domestic partners in California and in other states? What is substantially similar registration in other states? Doesn't Family Law say to treat registration in other states the same (see AB205). And Proposition 22 does not recognize marriage. If partnership is dissolved by 12/31/06, are there no CA tax consequences? Does dissolution sever community property? What is the State's interest in registration of domestic partners? Community property laws only for domestic partners that are registered? Will Attorney General provide guidance?	
3.	Do the exceptions that apply to military or NR, part-year residents, apply to registered domestic partners?	
Notes	The exception is not applicable because registered domestic partners are currently not allowed to file a joint federal return.	
4.	If a registered domestic partner chooses to file a California married filing separate return, how should they complete that return.	The registered domestic partner would use the same rules as applicable to a married person filing a separate return.
Notes	Will AGI be combined?	For AGI limitations, the federal numbers added together will be applied.
5.	Do registered domestic partners retain the right to file a state tax return with the same filing status as the federal?	No. Registered domestic partners are required to file a joint CA return or a separate CA return using the same rules applicable to married individuals.
Notes	No issues.	
6.	Do registered domestic partners combine the number of exemptions claimed on their separate federal returns to arrive at the total number of exemptions claimed on their California return?	The rules for claiming exemptions do not vary on the basis of your filing status.
Notes	No issues.	
7.	Can a registered domestic partner file as head of household (HOH) on a California return?	It appears that the answer should be that the same rules that allow a married person to file as HOH should apply to allow a registered domestic partner to file as HOH.
Notes	If information is going out to the public, add language with examples about HOH. There may be a lot of misunderstanding of who qualifies for HOH. Do not need to terminate registration to qualify as "considered unmarried" for HOH.	
8.	If one partner to a registered partnership dies, can the surviving domestic partner file a joint return?	Yes, same as a surviving spouse.
Notes	No issues.	

New Law Affecting Filing Status of Registered Domestic Partners
Discussion Material for FTB Focus Group Meeting
DRAFT Questions and Suggested Responses
RESULTS OF FOCUS GROUP (in red)

Line #	Question:	Suggested Response:
9.	Do registered domestic partners combine their federal adjusted gross income to arrive at the adjusted gross income for California before adjustments for their California joint return?	It appears that the answer should be that the gross income and AGI are computed on an aggregate basis. See Treas. Reg §1.6013-4(b).
Notes	R&TC Section 17024.5(h)(2)(B) contradicts suggested response to this question. Can we use a "deemed" federal AGI?	R&TC Section 17024.5(h)(2)(B) needs to be taken into context, this refers only to AGI limitations. Gross income of both parties would aggregate to derive a single joint return. However, some income would understate the AGI for purposes of limitations. So, for purposes of limitations combine the Federal AGI of both partners to determine CA joint return adjustments.
10.	Are there circumstances where taxpayers would add the AGI on their federal returns for computing the AGI on their joint state return?	Yes, when determining AGI limitations, registered domestic partners are required to combine their federal AGI's. Example, when figuring federal limitations, such as medical expenses, registered domestic partners filing a joint California return would use the combined AGI from their original federal returns.
Notes	Will FTB consider leniency for accuracy-related penalties for domestic partners?	
11.	How should tax preparers report community income? Community deductions? Separate expenses paid with community property funds?	It appears that the answer should be that you would use the same community property rules that you use now for married couples who are filing a separate return. You might want to keep a worksheet for your records and report the community property amount on the return.
Notes	What is FTB's position on expenses paid from community property?	This is a Family Law issue; other forms of ownership may apply to C.P.
12.	Do registered domestic partners combine their federal itemized deductions which may include unreimbursed employee business expenses and miscellaneous expenses to arrive at their California itemized deduction before CA adjustments?	It appears that the answer should be that itemized deductions on a joint return are computed in an aggregate amount. See response above.
Notes	What are mortgage interest implications?	In determining itemized deductions use aggregate amount; in determining limitations, use federal AGI amounts added together.
13.	How will Capital gains exclusion for the sale of a principal residence be treated for: \$250K/\$500K?	It appears that the answer should be that if the registered domestic partners meet the requirements under Internal Revenue Code section 121 as applicable for California and file a joint return, the amount excludible on the California joint return should be \$500,000. However, to minimize federal tax, registered domestic partners may choose different forms of property ownership.
Notes	No issues.	
14.	Can a registered domestic partner who filed a joint return apply for relief under California's innocent spouse provisions?	The ability to file for California innocent spouse relief applies to anyone who files a joint return.
Notes	No issues.	

New Law Affecting Filing Status of Registered Domestic Partners
Discussion Material for FTB Focus Group Meeting
DRAFT Questions and Suggested Responses
RESULTS OF FOCUS GROUP (in red)

Line #	Question:	Suggested Response:
15.	If there is a termination of a registered domestic partnership and a California Family Law court awards spousal support (alimony), what is the tax treatment of these payments?	If the payment satisfies the requirements under tax law for alimony, it appears that the answer should be that it would be deductible by the payor and includible by the payee. However, different federal treatment of these payments is uncertain. If a federal tax treatment of these payments is different, it may affect how the payments should be treated for state purposes as well.
Notes		Included in AB205 as an issue.
16.	If there is a termination of a registered domestic partnership and a California Family Law Court forces a division of mutually acquired property (acquired with separate and/or community funds), what are the tax considerations for gift, sale, part gift, or part sale? Could anything qualify for IRC Section 1041 or RT&C Section 18031 treatment?	If the property transfer satisfies the requirements under California tax law, it appears that the answer should be that the treatment is the same as for a property transfer by a married couple. However, to minimize federal tax, registered domestic partners may choose different forms of property ownership or transfer. (<i>United States v. Davis</i> (1962) 370 U.S. 65)
Notes	U.S. v. Davis does not apply to community property. Sec. 408, division of IRA, are you extending rationale to IRAs? Tax implications are more substantial for federal purposes than State; should base considerations on federal.	
17.	Will there be an estimated tax penalty computed on a 2007 joint return filed under the new law?	Since the new law is prospectively operative, the new law does not contain any provision regarding relief from the estimated tax penalty.
Notes	Are there Safe Harbor Limitations?	
18.	Your news bulletin indicates that the change would be effective for 2007 returns filed in 2008. However, 18521 deals with the determination of filing status for the purpose of filing PRIOR year returns. If the effective change to 18521 is as of 1/1/2007, then the determination of filing status should be for 2006 returns?	No, the new law applies beginning with returns filed for the 2007 taxable year.
Notes	No issues.	
19.	Will this mean that employees who are registered domestic partners will need to update their DE-4 from single to married?	Employees may want to update their DE-4 for California withholding purposes. However, note that no taxpayer is required to file a DE-4 as married.
Notes	How are employee benefits considered, e.g., Medicare Flex-elect; can RDPs only include \$5K limitation on a joint return? (DCB)	Law is unclear for qualified plans; FTB is performing an analysis to review the provisions of AB205.

**New Law Affecting Filing Status of Registered Domestic Partners
Results of Focus Group Meeting Held November 30, 2006
Additional Questions/Considerations**

Participants in the Focus Group held November 30, 2006, raised the following additional questions or considerations:

1. We would like to have more information on the business vs. personal applications of the law for registered domestic partners.
2. Private letter rulings have been requested from the IRS with several “split income” test cases.
3. Include in instructions that domestic partners can qualify as a surviving spouse; filing status would be Qualifying Widow(er).
4. The deductibility of an IRA, how do we advise taxpayers? Roth IRAs may be denied contribution under state law. All federal contribution changes are operative to California.
5. Will there be legislative changes after all issues are identified?
6. Legislative changes would be more beneficial if initiated earlier.
7. Self-employed health insurance deduction (Section 162(1)(2)(6)): are RDPs no longer eligible to deduct under state law? Health policy issues—how will they be considered for income purposes?
8. Will FTB require the attachment of a federal return for RDP returns?
9. Would like FTB to provide information or testimony to support changes in federal law; i.e., the problems created by lack of conformity.
10. CP2000s will require manual workloads for FTB; i.e., two CP2000s for one return.
11. Third-party information shared with FTB could cause issues.
12. Consider a separate box for RDP filing status – but privacy concerns noted.
13. Include article in January Tax News asking for input on issues.
14. Provide comprehensive guide reflecting difference in federal/state laws, subject to stakeholder review. A publication that addressed the federal/state differences would be helpful to practitioners.
15. Send letters through Secretary of State advising RDPs of law changes.
16. Will FTB request proof of RDP registration with Secretary of State?
17. AGI limitations- combining income:
 - Software firms will have difficulty programming a third federal joint return for computing adjustment on the California return.
 - Manual work will be required for third return preparation.
 - RDPs cannot use separate preparers.
 - Preparers will not have time to prepare RDP returns for all their clients, necessitating extensions to file.
20. Will nonresident RDPs going in and out of CA recomputed based on rules of other state(s)?
21. Prepare RDP community for new filing requirements.

22. Overriding social issues need to be further studied.
23. Conflict of interest rules should apply.
24. On corporate returns related parties who are RDPs will have different tax treatment for state.
25. Differences between federal and state basis for recordkeeping purposes.

Given the requirements of the new law, what should the RDP California return look like?

1. Prepare dummy federal return and send to state.
 - Is e-file possible with a dummy return?
2. Prepare something similar to Schedule CA for simpler returns.
3. Include two columns on Schedule CA for each partner.
4. Only required first two pages of federal return.
5. A concern about identifying RDPs as a separate group if a special filing status (RDP) is used, resulting in possible loss of social security, etc.
6. Prepare a stand-alone 540, include summary of federal information that shows adjustments.
7. Pro-forma return, limiting income to everything above the line.
8. Create a worksheet that incorporates both federal AGI's and used to file with the state return in lieu of attaching two separate federal returns.

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November 27, 2006

Executive Committee, Taxation Section
The State Bar of California

Re: Your June 15, 2006, Letter Supporting SB 1827

Dear Executive Committee, Taxation Section:

On June 15, 2006, the Executive Committee of the Taxation Section of the State Bar of California addressed a letter to Larry Doyle, Chief Legislative Counsel, in support of SB 1827. The Executive Committee stated it "is interested in and supportive of any measure that provides certainty, fairness and clarity" in the application of California tax law. SB 1827 unfortunately provides neither certainty, nor fairness, nor clarity in the application of California tax law.

The Executive Committee justified its support for SB 1827 with the statement:

"The application and administration of California's tax laws is within the area of special knowledge, training, experience or technical expertise of the members of the Executive Committee of the Taxation Section."

The members of the Executive Committee may have "special knowledge, training, experience or technical expertise". The members of the Executive Committee did not utilize the abilities they claim to have.

The decision to support SB 1827 may have been an appropriate personal decision for each of the members of the Executive Committee. The decision to support SB 1827 may have been an astute political decision for each of the members of the Executive Committee. However, the decision to support SB 1827 fell far below the standard of care that is required of tax lawyers in providing analysis and advice.

It is my belief Senator Migden was well-intentioned in sponsoring SB 1827. It is my understanding Senator Migden believed she was correcting a wrong. It is my understanding Senator Migden believed she was granting a privilege to registered domestic partners that they had been denied in AB 205. Senator Migden is not a tax lawyer. If Senator Migden consulted a tax lawyer regarding SB 1827, she was poorly advised. Consequently, SB 1827 has imposed an additional economic burden on the tax system, yet provided little, if any, benefit for the constituency Senator Migden intended to benefit.

There have always been problems as a result of the inter-play between California's community property laws and the reporting of income by spouses. AB 205 extended the problems caused by the inter-play between California's community property laws and the reporting of income by spouses to registered domestic partners by extending community property rights to registered domestic partners. However, SB 1827 did not solve these problems for registered domestic partners. SB 1827 compounded these problems for registered domestic partners. As a consequence of SB 1827, registered domestic partners have more income tax reporting problems than they had before SB 1827, and they have more income tax reporting problems than conventional spouses.

If the motivation for SB 1827 was to correct a perceived unfairness in the income tax laws for registered domestic partners vis-a-vis conventional spouses, the issue was largely imaginary. There were potential income tax filing problems for registered domestic partners prior to SB 1827, but these problems existed largely for the uninformed and the ill-advised. If the minimization of income tax liabilities is a tax benefit for taxpayers, prior to enactment of SB 1827 well-informed and well-advised registered domestic partners were in a better income tax position than conventional spouses.

AB 205 granted to registered domestic partners the status of marriage for all purposes under the California income tax laws with a few exceptions. One of the privileges of marital status is the ability to transmute future income from separate income into community income, or from community income into separate income. Conventional spouses and registered domestic partners are related parties for the purposes of support obligations, etc., and the transmutation of future income does not violate assignment of income principles for that reason. (Family Code §297.5 appears to limit the transmutation privilege by specifying that earned income cannot be treated as community property for California income tax filing purposes.) Prior to SB 1827 registered domestic partners had the benefit of the single filing status, and the ability to allocate and divide income with the possible exception of earned income. Well-advised registered domestic partners were far better situated to deal with income tax issues than conventional spouses prior to SB 1827.

Registered domestic partners must file as if they were married for California income tax purposes as a result of SB 1827. SB 1827 complicates the lives of registered domestic partners for filing purposes, and imposes on registered domestic partners the burden of marital filing status. There is little, if any, benefit to registered domestic partners in SB 1827 from an income tax planning view-point. In most instances SB 1827 creates an additional income tax cost for the taxpayers impacted, and it creates a substantial burden on the administration of California's income tax laws. The status of filing a return reflecting marital status may be perceived as a benefit to registered domestic partners by some, but a thoughtful tax lawyer knows better.

If the members of the Executive Committee want to appropriately discharge their responsibilities as leaders and spokespersons for the California tax community, the members of the Executive Committee should devote their efforts to seeing SB 1827 is promptly repealed. If the members of the Executive Committee are want to do something truly worthwhile, they should devote their efforts to addressing the problems created by the inter-play between California community property laws and spousal income tax filings.

The inter-play between California community property laws and spousal income tax filings has always been a problem for some taxpayers. It has always been a serious problem for those few taxpayers who become ensnared in its traps. This problem existed long before the concept of registered domestic partners was first introduced to the California legislature. AB 205 extended the problems created by the inter-play between California community property laws and spousal income tax filings to registered domestic partners by applying California's community property laws to registered domestic partners.

There is a solution to many of the problems created by the inter-play between California community property law and spousal income reporting. The solution is equally applicable to conventional spouses and registered domestic partners. However, you must turn to the source of these problems - the inter-play between California community property law and income reporting for tax purposes - to solve these problems.

The California legislature has never been inclined to solve these problems for conventional couples. Registered domestic partners face the same problems with or without AB 1827. The members of the Executive Committee, exercising the abilities they claim, could devote their efforts to solving these problems for both registered domestic partners and conventional couples by addressing the issues that prompted Senator Migden's well-intentioned, but ill-considered, legislation.

Very truly yours,

TAGGART & HAWKINS

/s/ William E. Taggart, Jr.

William E. Taggart, Jr.

WET/tw
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cc: Honorable Carole Migden
Larry Doyle, Chief Legislative Counsel

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November 27, 2006

Deborah Newcomb
Taxpayer Advocate
FRANCHISE TAX BOARD
P.O. Box 157
Sacramento CA 95741-6614

Re: Focus Group Meeting Re: SB 1827; November 30, 2006

Dear Ms. Newcomb:

Thank you for inviting me to the Franchise Tax Board's Focus Group Meeting to discuss the filing problems that have been thrust upon the Franchise Tax Board by the passage of SB 1827. I was aware of the passage of SB 1827, but I did not anticipate the Governor Schwarzenegger would allow the legislation to become law. I thought the legislation would be vetoed because it creates additional costs for the Franchise Tax Board and taxpayers, but provides little, if any benefit, to the group effected by the legislation. As I advised you in our telephone conversation, my partner and I intend to de-register prior to the end of 2007 in order to avoid the additional tax liabilities SB 1827 creates for us.

I have enclosed for your reference a copy of the letter I have sent to the Focus Group as well as a copy of my letter to the Executive Committee of the Taxation Section of the State Bar of California. SB 1827 makes the proposal for which I sought the support of your office last year even more important. If SB 1827 is not repealed, even more California taxpayers face the problems that are created by the inter-play between California community property law and the reporting of income by conventional spouses and registered domestic partners for income tax purposes.

Very truly yours,

TAGGART & HAWKINS

/s/ William E. Taggart, Jr.

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Enclosures: As stated

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November 27, 2006

Focus Group Meeting Re: SB 1827
FRANCHISE TAX BOARD
Sacramento, California

Re: Focus Group Meeting Re: SB 1827; November 30, 2006

Dear Franchise Tax Board Focus Group:

Enclosed please find a copy of a letter I have sent to the Executive Committee of the Taxation Section of the State Bar of California on November 27, 2006, regarding the Executive Committee's support for SB 1827. Enclosed also please find a copy of my letter to Deborah Newcomb, Taxpayer Advocate for the Franchise Tax Board, who advised me of your focus group meeting.

Ms. Newcomb advised me of your November 30th meeting because she was aware of my interest in filing issues for registered domestic partners. As a consequence of a telephone call from Ms. Newcomb, I sent an e-mail message indicating I would attend your meeting. However, based on my review of the agenda for your meeting, as well as the materials you prepared and distributed in preparation for the meeting, there is little I can contribute to your discussion of the filing problems created by SB 1827. I have little knowledge regarding the details of tax return preparation.

I would like my letter to the Executive Committee to be included in the record of your meeting. I applaud the efforts of the Franchise Tax Board to deal with the very difficult filing questions that have been created as a consequence of the passage SB 1827. California's income tax filings are fundamentally entwined with federal income tax filings. SB 1827 creates one additional, and very complicated, disconnect between California's income tax filings and federal income tax filings. SB 1827 creates significant and complex income tax filing issues for a small group of taxpayers while providing little, if any, benefits to the taxpayers effected by this legislation.

If the Franchise Tax Board has not already done so, I encourage the FTB to actively seek the retroactive repeal of SB 1827. If SB 1827 is retroactively repealed prior to December 31, 2007, this legislation will never become effective as a practical matter. Neither California taxpayers, nor the FTB, will have to deal with myriad of problems that were created by the passage of SB 1827.

For most couples, whether conventional couples or registered domestic partners, there is little, if any, benefit for California income tax purposes in being required to, or in being granted the privilege of, filing a joint income tax return or returns as married filing separately.

My partner and I had the accountant who prepared our respective income tax returns for 2005 compute our California income tax liabilities for 2005 as if we had filed joint California income tax returns. Our combined California income tax liability would have been \$2,027 greater if we had filed a joint California income tax return instead of the separate income tax returns we filed. If we had filed as married filing separately, our California income tax liability would have been \$2,101 greater. In addition the accountant who prepared our income tax returns would have charged us an additional \$300-\$500 for the preparation of our returns because of the complexities created by SB 1827.

There is a solution to many of the income tax issues that SB 1827 was supposed to address. I have discussed these problems with Deborah Newcomb, Taxpayer Advocate for the Franchise Tax Board, on multiple occasions.

As long as couples (or registered domestic partners) agree, and report all income, the issues created by the disconnects between property interests in income and the reporting of such income are minimal. Unreported income creates problems. If such income is "community income" in which each party to the community is deemed to have an equal interest, one-half of such income is reportable, and taxable, to each party to the community.

As I have briefly indicated above, and as I have discussed in detail with Deborah Newcomb on multiple occasions, there is a solution to most of the issues that are created by disconnects between California community property law and the reporting of income for income tax purposes. If the property interests in such income are defined, as a matter of California community property law, to be after-tax interests, and the obligation to report, and to pay income tax on such income is primarily based on possession and control of the income, the problems that arise as a consequence of the inter-play between California's community property laws and income tax reporting obligations largely disappear.

If you have any questions regarding the preceding or the enclosed, please feel free to contact me.

Very truly yours,

TAGGART & HAWKINS

/s/ William E. Taggart, Jr.

William E. Taggart, Jr.

WET/tw
K27RJFOCUS2.wpd

Enclosures: As stated

Anne Miller
Franchise Tax Board
Via Email

November 28, 2006

Dear Anne,

Thank you for the advance agenda and discussion materials for this weeks FTB Focus Group meeting on California's Registered Domestic Partners. We will be attending the meeting this Thursday in Sacramento and look forward to meeting you then.

I apologize for not submitting questions and comments to you sooner but since I have now had a chance to review the materials you sent out I do have questions and comments and thought it would still be helpful to you to receive these ahead of the meeting on Thursday.

Alternative Approaches

In my discussions with other tax professionals we have been unclear as to which of two separate approaches should be utilized to calculate the combined AGI amounts for the 2007 and later California tax returns of RDPs. (Notwithstanding that there may be more than two approaches, or some combination that is appropriate.) Nevertheless in our discussions we have focused on the following two approaches:

1. Complete the federal tax returns individually exactly as you would for federal filing purposes. Then for the California joint return simply sum from the two separate Federal 1040 returns the amounts shown on Line 37 – “Adjusted Gross Income.” And on CA Form 540 Part II, for itemized deductions again simply sum the amounts from the two single federal returns. From that point make any required California adjustments as would apply to any other California taxpayer filing a joint return and perhaps some special RDP adjustments specifically with respect to IRAs.
2. Recalculate the federal tax returns assuming a federal income tax filing status of “Married Filing Joint” or “Married Filing Separate”, and then carry forward from that non-filed federal tax return the appropriate amount from Line 37 – “Adjusted Gross Income” and from Schedule A, itemized deductions. From that point make any required California adjustments as would apply to any other California taxpayer filing a joint return and perhaps some special RDP adjustments specifically with respect to IRAs.

While in some simpler circumstances these two approaches would produce the exact same number to be carried forward to the California joint tax return, in many cases it would not.

The argument for the first approach is the ease of applicability for both the tax preparers in California as well as the CA RDPs who prepare their own tax returns. And of course this approach would result in less revision required of the tax software that most of us use. However, I agree that if the ultimate goal is for a California Registered Domestic Partner to file a California tax return that would as nearly as possible mimic the tax return that would be filed if that RDP were a legally married taxpayer in California, then the approach delineated above under option 2. would certainly come closer to that goal.

It appears to me that on the DRAFT Questions you provided in Question #9 Option 2 is implied and in Question # 10 Option 1 is implied. This highlights how confusing the terminology can be and how clear the communication must be in order for RDPs to file accurate tax returns in California.

Approach 2 Comments

Assuming Option 2 is the appropriate goal I would offer these comments and recommendations as to methodology. I can't imagine it being feasible for a tax preparer or a CA RDP with any complexity at all on their tax return to calculate an appropriate California return without first actually doing the federal return under the MFJ or MFS status. To start at the single federal return and to incorporate all of the changes that would be required to get to an accurate CA married return without this interim step would be cumbersome at best and the communication required from the FTB as to how to do so would be extensive, as would the changes required to the CA 540 and the tax software packages. This is because any number of items on the federal return Form 1040 pages 1 & 2 could change.

Form 1040 Pages 1 & 2 Changes:

Line 13 – Capital gains or losses

When filing as two single individuals the RDPs could each offset all of their capital gains with capital losses, and if losses exceeded gains they could each get an additional loss of \$3,000 for a grand total of \$6,000. If they were filing jointly as married, instead of \$6,000 of losses, they would be limited to \$3,000 in total. Also, while filing as two separate individuals they can only offset their own gains with their own losses but if filing jointly as married the losses of one partner would be able to offset the gains of the other partner.

Line 15 – IRA distributions

While this line itself might not change, there could be significant IRA differences between federal tax treatment and California tax treatment for RDPs due in part to eligibility requirements for contributions to ROTH-IRAs and eligibility requirements for conversions of other IRAs to ROTH-IRAs. (See additional IRA discussion later.)

Line 17 – Rental Real estate, S-Corp, Partnerships, etc

Again there could be significant differences on this line under the two approaches. Since total passive real estate losses are limited to \$25,000 for federal purposes and are phased out when your federal AGI exceeds \$100,000 and then eliminated completely when your federal AGI exceeds \$150,000 conceivably the two single RDP filers could have losses of \$50,000 combined under approach 1 but would only be allowed a total loss of \$25,000 under approach 2 considering the passive items only.

Line 20 – Social Security benefits

The amount of social security benefits to be included in federal AGI depends on the total income for the taxpayer. If the income for both of the RDPs is combined then the amount used to determine the portion that is taxable would change. Also the dollar limit to use is different for single and married individuals.

Line 24 – IRA Deduction

(See additional discussion later on the thorny IRA issues.)

Line 25 – Student Loan interest

Again, the ability to deduct student loan interest is tied to an AGI phase-out, when the federal returns are filed as single one taxpayer may be able to deduct student loan interest but could lose this deduction if filing jointly.

Line 27 – Moving Expenses

I haven't done a thorough analysis here but I believe there could be differences with perhaps more moving expenses allowed as a deduction under a jointly filed return where one partner is working and the other is not.

Line 29 – Self-employed Health Insurance

When looking at this deduction for the two separate single federal returns it is irrelevant to a self-employed RDP if her partner has health insurance at work that offers domestic partner coverage. However, if we are using approach 2 to simulate a married filing joint return for this couple then the self-employed RDP could lose this deduction.

All of these differences would change the overall federal AGI amount on Line 37. This amount used to calculate the applicable floors for the Itemized Deductions on federal Form 1040 Schedule A as well as to determine the overall phase-out of federal itemized deductions for these taxpayers. The federal itemized deductions are also carried forward to the California 540, Part II.

Form 1040 – Schedule A Changes

Plus, even after the appropriate AGI is determined and the new floor amount for Schedule A is calculated (7.5% for medical, 2% for misc. itemized) there could also be changes to the Schedule A itself such as:

Schedule A - Mortgage Interest Deductions

For example the deductible mortgage interest could be limited. The overall federal limit is \$1,000,000 for qualified acquisition debt and \$100,000 for other secured mortgage debt. For two RDPs filing as single they could conceivably be deducting mortgage interest for a combined \$2,200,000 worth of debt but if the return is prepared to mirror a married filing joint return this would be limited to \$1,100,000.

Schedule A – Investment Interest Expense Deduction

Also, for investment interest expenses the deduction allowed for the joint return could be higher than that allowed for the combined single returns because now the investment interest expenses of one RDP could be used to offset investment income of the other RDP. Would a separate CA election be required to include capital gains as investment income?

Schedule A – Charitable Contributions Deduction

Charitable contribution limits calculated under approach 1 and approach 2 could also differ dramatically if contributions limit are being imposed.

Given all of these considerations, and this is certainly not an exhaustive list although I've tried to highlight what I see as the most frequently occurring differences, you can appreciate how trying to explain and communicate these differences would be onerous for the FTB without referencing back to federal law, and trying to properly calculate these differences would be cumbersome for the tax preparer or the RDP without using federal tax software for a MFJ or MFS tax return. Therefore, assuming approach 2 is desired or required, I would suggest the FTB develop a system that calls for two separate layers of adjustments.

Suggested Methodology for Approach 2

- 1) Calculate the two separate **federal** tax returns for the RDPs as single taxpayers as actually filed with the IRS (or as would be filed with the IRS as single if no return is required) and attach a copy of this return to your California tax return. Carry forward to the jointly filed CA tax return the sum of these two amounts for AGI and for itemized deductions.
- 2) Calculate a **federal** tax return for the RDPs as either one MFJ return or two MFS federal returns using applicable federal law as it applies to legally married persons. Also file a copy of these tax returns with the FTB. (??)
- 3) Perhaps require a new special schedule that shows the federal Lines 7 – 37 under each of these two tax returns with Column 1 showing the two separate single numbers added together, Column 2 showing either the two MFS returns added together or the one MFJ return lines, and Column 3 showing the difference. This report would essentially show the changes required due to federal tax law differences for single and married individuals. You might also want to include the Schedule A items on this report.
- 4) For the CA tax return add a line between Lines 13 and 14 that would ask for the AGI adjustment amount for federal differences from this new report. So that the CA joint return will start with the sum of Line 37 for each of the two single federal returns as filed, and then it will adjust this amount as appropriate to bring it into line with a MFJ or MFS federal status.
- 5) Continue with the normal California adjustment items from Schedule CA and add any special RDP adjustment lines to this schedule. (Especially see IRA discussion.)
- 6) Change CA Form 540 Part II to again accommodate the changes to federal itemized amounts from single to MFJ or MFS by adding lines to Part II, i.e. start with combined single return numbers, and then show total adjustment required from the new Form as in Step 3 above.

IRA Discussion

And finally, for the promised IRA discussion –

ROTH-IRAs

Under approach 2. you could have a taxpayer who is allowed under federal law to make a ROTH-IRA contribution but who would not have been allowed to make this contribution when combining income under a simulated MFJ or MFS return. This is because any taxpayer who chooses to file as MFS is not allowed to make any ROTH-IRA contribution, and for those filing as MFJ the combined AGI limit will be different and this limit could very likely be exceeded again resulting in no ROTH-IRA contribution being allowed.

While the ROTH-IRA contribution itself does not generate a tax deduction, and so there is no issue in that regard, the issue becomes the earnings on the ROTH-IRA account, and when or how these should be included in CA income. If the interpretation of the new California domestic partner law is that this taxpayer is not eligible for a ROTH –IRA for California purposes, we have special adjustments that would be required because now we have a federal to CA difference that applies only to RDPs with respect to ROTH-IRAs. We now have a ROTH-IRA account that is generating gains and losses, interest income, etc. that is taxable for CA purposes but not for federal purposes. Therefore the California Form 540 Schedule CA would need to be adjusted to include interest income, dividend income and capital gains and losses from the ROTH IRA account. Presumably this income would be taxed for California purposes in the year that it is earned as opposed to the year that it is distributed from the account? Also there would need to be some sort of reporting mechanism for ROTH-IRA custodians to report these amounts out to taxpayers and to the FTB so that they could be included in the California tax return.

Also as mentioned above, there could be taxpayers who are eligible to do an IRA conversion into a ROTH-IRA for federal purposes but not for California tax purposes. Again since the conversion amount is taken into income for both federal and California that is not the issue, the issue becomes the income earned on the new ROTH-IRA account.

Spousal IRA Deduction

Finally, while the ROTH-IRA tax benefits may be taken away from an RDP taxpayer for California purposes there seems to be no mechanism for a Spousal-IRA deduction to be allowed to an RDP taxpayer. If true tax parity is desired (required ?) for CA RDPs versus couples who are legally married in California, then some mechanism would need to be added to allow a spousal-IRA account that could generate both an IRA deduction and deferral of income earned in that IRA for California RDPs only. This would need to be a

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new type of account in California that would be taxable on a federal level but tax deferred on a California level.

Anne, while I'm sure we won't have sufficient time at Thursday's meeting to deal in this level of detail I hope these comments are useful to you. I look forward to meeting you.

Sincerely,